THE RULE OF LAW AND WALL STREET – PART II

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Mr. President, as we continue to learn more facts from various investigations into the 2008 financial meltdown, a certain picture is becoming increasingly clear. Like a jigsaw puzzle slowly taking shape, we can begin to see the outlines of many of the causes of the crisis — and the solutions that they demand.

In my view, it is a picture of Wall Street banks and institutions that have grown too large and complex and that suffer from irreconcilable conflicts between the services they provide for their customers and the transactions they engage in for themselves. It is also a picture of management that either knew about the lack of financial controls and outright fraud at the very core of these institutions — or was grossly incompetent because it did not. And the picture includes regulators who failed miserably as well, due to malfeasance or incompetence or some combination of the two.

Until Congress breaks these gigantic institutions into manageably sized banks and draws hard, clear lines for regulators to ensure that effective controls remain in place, we will have done neither that which is necessary to restore the rule of law on Wall Street nor that which will ensure that another financial crisis does not soon happen again.

What have we learned in just the past five weeks? On March 15th, I came to the Senate floor to discuss the Bankruptcy Examiner's report on Lehman Brothers and said — as many of us have suspected all along — that there was fraud at the heart of the financial crisis. The examiner's report exposed the use of so-called Repo 105 transactions and what appears to have been outright fraud by Lehman, its management and its accounting firm, who all

conspired to hide $50 billion in liabilities at quarter's end to "window dress" its balance sheet and mislead investors. And this practice does not appear to be unique to Lehman Brothers.

I went further and noted that questions were being raised in Europe about whether Goldman Sachs had an improper conflict of interest when it underwrote billions of Euros in bonds for Greece. The questions being raised include whether some of these bond-offering documents disclosed the true nature of these swaps to investors, and, if not, whether the failure to do so was material.

Last week, we learned about more alleged fraud at the heart of the financial crisis. On Friday, the Securities and Exchange Commission filed charges against Goldman Sachs and one of its traders for alleged fraud in the structuring and marketing of collateralized debt obligations tied to subprime mortgages. Goldman allegedly defrauded investors by failing to disclose conflicts of interests in the design and structure of these collateralized debt obligations. The SEC says this alleged fraud cost investors more than $1 billion. While I will not prejudge the merits of the case, the SEC's complaint alleges that Goldman Sachs failed to disclose to investors vital information about the CDO, in particular the role that a major hedge fund played in the portfolio selection process and that the hedge fund had taken a short position against the CDO.

Robert Khuzami, Director of the SEC Division of Enforcement, said "Goldman wrongly permitted a client that was betting against the mortgage market to heavily influence which mortgage securities to include in an investment portfolio, while telling other investors that the securities were selected by an independent, objective third party." Kenneth Lench, Chief of he SEC's Strucured and New Products Unit, added "The SEC continues to investigate the practices of investment banks and others involved in the securitization of complex financial products

tied to the U.S. housing market as it was beginning to show signs of distress." Goldman Sachs has denied any wrongdoing and has said it will defend the transaction.

This particular case involving Goldman Sachs was almost certainly not unique. Instead, it was emblematic of problems that occurred throughout the securitization market. Late last month, Bob Ivry and Jody Shenn of Bloomberg news wrote about the conflicts of interests present in the management of CDOs, a topic also discussed at length in Michael Lewis' book *The Big Short*. The SEC should pursue other instances of conflicts of interest in the CDO market that led to a failure to disclose material information.

Mr. President, last year Senators Leahy, Grassley and I, along with many others in the Congress, worked to pass the bipartisan Fraud Enforcement and Recovery Act, so that our law enforcement officials would have additional resources to target and uncover any financial fraud that was a cause of the financial crisis. However long it takes, whatever resources the SEC needs, Congress should continue to back the SEC and the Justice Department in their efforts to uncover and prosecute wrongdoing.

I applaud SEC Chairman Mary Schapiro and especially Rob Khuzami and the team he has reshaped in the Enforcement Division. They deserve our steadfast support as the leadership of the SEC continues its historic mission of revitalizing that institution and making it clear to all on Wall Street that there's a new cop on the beat.

Also last week, our colleague, Chairman Carl Levin, Ranking Member Coburn and the staff on the Permanent Subcommittee on Investigations began a series of hearings on the causes of the financial crisis. It is a testament to the professionalism and dedication of Chairman Levin that he has brought the

Subcommittee's resources to bear in such an effective and thorough manner. I also want to commend Ranking Member Tom Coburn for his dedication and effort as a partner in this effort. Chairman Levin and the Subcommittee staff deserve credit and our deep appreciation for the work that they have put into this series of hearings on Wall Street and the financial crisis. Since November 2008, Subcommittee investigators have gathered millions of pages of documents, conducted over 100 interviews and depositions, and consulted with dozens of experts. It is truly a mammoth undertaking and the fruits of their labor were evident in last week's two hearings on Washington Mutual Bank. I look forward to the Subcommittee's remaining two hearings on this subject, including this Friday's hearing on the role of the credit ratings agencies. I urge my colleagues to watch.

The Levin hearings deserve comparison to the legendary Pecora investigations of the 1930s, which were held by the Senate Committee on Banking and Currency to investigate the causes of the Wall Street Crash of 1929. The name refers to the fourth and final chief counsel for the investigation, Ferdinand Pecora, an assistant district attorney for New York County. As chief counsel, Pecora personally examined many high-profile witnesses, who included some of the nation's most influential bankers and stockbrokers. The investigation uncovered a wide range of abusive practices on the part of banks and bank affiliates. These included a variety of conflicts of interest, such as the underwriting of unsound securities in order to pay off bad bank loans as well as "pool operations" to support the price of bank stocks.

The Pecora hearings galvanized broad public support for new banking and securities laws. As a result of the Pecora investigations's findings, the Congress passed the Glass-Steagall Banking Act of 1933, to separate commercial and investment banking; the Securities Act of 1933, to set penalties for filing false information about stock offerings; and the Securities Exchange Act

of 1934, which formed the SEC, to regulate the stock exchanges. Thanks to the legacy of the Pecora hearings and subsequent legislation, the American financial system rested on a sound regulatory foundation for roughly half a century. That is, until we began the folly of dismantling it.

The Levin hearings have shined a much-needed spotlight on the role of potential outright fraud by financial actors as well as the incompetence and complicity of bank regulators in the financial crisis. There is no better example of the danger that fraud and lax regulation poses to our financial system than the collapse of Washington Mutual, known as WaMu.

Far too often, the failure of institutions like Washington Mutual is blamed on high-risk business strategies. While such strategies are clearly part of the problem, they should not be used to mask other causes, such as fraud and malfeasance, which played a significant role in the collapse of WaMu. Evidence developed by the subcommittee demonstrates that WaMu officials tolerated, if not outright encouraged, fraud as a byproduct of promoting a dramatic expansion of loan volume.

The most blatant example of WaMu's culture of fraud was its widespread use of "stated income" loans – a practice of lending qualified borrowers loans without any independent verification of their income. Approximately 90 percent of WaMu's home equity loans, 73 percent of its Option ARMs, and 50 percent of its subprime loans were "stated income" loans. As Treasury Department Inspector General Eric Thorson said last week, WaMu's predominant mix of stated income loans created a "target rich environment" for fraud.

Because WaMu made these stated income loans with the intent to resell them into the secondary market, it was less concerned whether borrowers would be able to repay them.

WaMu created a compensation system that rewarded employees with higher commissions for selling the riskiest loans. In 2005, WaMu adopted what it called its "High Risk Lending Strategy" because those loans were so profitable. In order to implement this strategy, it coached its sales branch to embrace "the power of yes." The message was clear. As one industry analyst said, "if you were alive, they would give you a loan . . . if you were dead, they would still give you a loan."

That this culture led to fraud on a massive scale should have surprised no one. An internal review of one Southern California loan office revealed that 83% of loans contained instances of confirmed fraud. In another office, 58% of loans were confirmed to be fraudulent. And what did WaMu management do when it became clear that fraud rates were rising as housing prices began to fall? Rather than curb its reckless business practices, it decided to try to sell a higher proportion of these risky, fraud-tainted mortgages into the secondary market, thereby locking in a profit for itself even as it spread further contagion into the capital markets.

In order for WaMu and institutions like it to sell these low-quality loans to the secondary market, they needed a AAA rating from the credit rating agencies. So what did these institutions do? They gamed the system and manipulated the agencies by engaging in a practice called "barbelling." Apparently, the credit ratings agencies did not examine individual FICO scores when rating mortgage-backed securities, and instead relied on average FICO scores. As revealed at the hearing by a WaMu risk officer, and detailed in Michael Lewis' *The Big Short*, lenders could create the requisite average score by pairing loans whose borrowers had relatively high scores with borrowers whose scores were far below levels that would normally warrant a loan. So if the raters wanted an average FICO score of 615, a lender could pair scores of 680 with scores of 550, even though borrowers with scores of 550 were

almost certain to default. This "barbell" effect satisfied the rating agencies, even though half the loans had little chance of success. At the hearing, WaMu CEO Kerry Killinger effectively admitted to barbelling, while saying "I don't have the barbell numbers in front of me."

To make matters worse, WaMu secured high FICO scores by seeking out borrowers with short credit histories. Such borrowers often have high FICO scores even though they have not demonstrated the ability to take on and pay off large debts over time. These borrowers were called "thin files" borrowers. According to a report in *The New York Times*, WaMu encouraged "thin file" loans, even circulating a flier to sales agents that said, "a thin file is a good file." *The Big Short* even discusses "a Mexican strawberry picker with an income of $14,000 and no English" that was ostensibly given a $724,000 mortgage on the basis of his "thin file."

Plainly, the Office of Thrift Supervision failed miserably in its responsibility to regulate WaMu, and to protect the public from the consequences of WaMu's excessive and unwarranted risk taking, including the toleration of widespread fraud. Although WaMu comprised fully 25% of OTS' regulatory portfolio, OTS adopted a laissez-faire regulatory towards WaMu. Although line bank examiners identified the high prevalence of fraud and weak internal controls at WaMu, OTS did virtually nothing to address the situation. In fact, OTS advocated for WaMu among other regulators and even actively thwarted an FDIC investigation into WaMu during 2007 and 2008. The complete abdication of regulatory responsibility by OTS may find sad explanation in the fact that OTS was dependent upon WaMu's user fees for 12-15% of its budget.

The regulatory failures of OTS were not unique. The overall regulatory environment at the time was extremely deferential to the

market, based on the widespread but faulty assumption that markets can and will effectively self-regulate. At last Friday's hearing, the testimony of the Inspector General of the Department of the Treasury was particularly noteworthy. He said that banking regulators "hesitate to take any action, whether it's because they get too close after so many years or they're just hesitant or maybe the amount of fees enters into it . . . I don't know. But whatever it is, this is not unique to WaMu and it is not unique to OTS." Let me repeat, it was the conclusion of our Treasury Department's inspector general that the failure of regulators to harness the lawless nature of conflicted institutions was not unique to Washington Mutual or to the Office of Thrift Supervision.

Mr. President, I have said before and I will say it again: it is time that we return the rule of law to Wall Street, where it has been seriously eroded by the deregulatory mindset that captured our regulatory agencies over the past 30 years. We became enamored of the view that self-regulation was adequate, that "enlightened" self-interest would motivate counterparties to undertake stronger and better forms of due diligence than any regulator could perform, and that market fundamentalism would lead to the best outcomes for the most people. Transparency and vigorous oversight by outside accountants were supposed to keep our financial system credible and sound. The allure of deregulation led us instead to the biggest financial crisis since 1929, and to former Federal Reserve Chairman Alan Greenspan's frank admission that he was "deeply dismayed" that the premise of enlightened self-interest had failed. And now we're learning, not surprisingly, that fraud and lawlessness were key ingredients in the collapse as well.

As we turn to financial regulatory reform, we must remember that effective regulation requires not only motivated and competent regulators but also clear lines drawn by Congress. Based on what we have learned, what must we do?

First, we must undo the damage done by decades of deregulation. That damage includes financial institutions that are too big to manage and too big to regulate (as former FDIC Chairman Bill Isaac has called them), a "wild west" attitude on Wall Street in which conflicts of interest are rampant and lead to fraudulent behavior, and colossal failures by accountants and lawyers who misunderstand or disregard their role as gatekeepers. The rule of law depends in part on having manageably sized institutions, participants interested in following the law, and gatekeepers motivated by more than a paycheck from their clients.

That's why I believe we must separate commercial banking from investment banking activities, restoring a modern version of the Glass Steagall Act to end the conflicts of interest at the heart of the financial speculation undertaken by megabanks that are "too big to fail." We further should limit the size of bank and non-bank institutions, something Senator Sherrod Brown and I will propose in legislation we plan to introduce this Wednesday. Otherwise we will continue to hear these mega-banks claim they are merely "market-makers," and no one who deals with them should trust whether the very creator of a financial product they sell is secretly betting against its success.

Second, we must help regulators and other gatekeepers not only by demanding transparency but also by providing clear, enforceable rules of the road wherever possible. One clear lesson of the Goldman allegations is that we need greater transparency and disclosure of counterparty positions in over-the-counter derivatives. We should mandate that derivatives are traded on an exchange or at least centrally cleared. The rare exemption should carry with it a reporting requirement so that all counterparties understand the positions being taken by other clients of the dealer firm.

Clearly, we need to fix a broken securitization market. No market, regardless of how sophisticated its participants, can function without proper transparency and disclosure. While I am pleased that the current reform bill would direct the SEC to issue rules requiring greater disclosure regarding the underlying loans in an asset-backed security, I believe that we must go further still. Requirements for disclosure should not merely begin and end at issuance. Instead, disclosures should be automated, standardized and updated on a timely basis, providing investors with relevant information on the performance of the loans, their compliance with relevant laws (fraudulent origination, for example, is generally uncovered after the fact), and their replacement by new collateral. This information would empower investors and countervail the malfeasance of issuers looking to "adversely select" dodgy collateral that they are also shorting on the side. Moreover, such real-time monitoring by investors would also have beneficial effects further up the securitization supply chain. If originators know that they can't get away with selling fraudulent or poorly underwritten loans, they will also be forced to improve their standards.

While not a silver bullet, I am also generally supportive of requirements that those who originate and securitize loans retain risk by keeping some percentage on their balance sheets. WaMu, for example, developed, in Senator Levin's words, a "conveyor belt" that originated, packaged and dumped toxic mortgage products downstream to unsuspecting investors. Their lack of "skin in the game" allowed them to make a mockery of the "originate to distribute" model. And while Bear Stearns, Lehman Brothers and other firms faltered due to their excessive retention of risk, this basic requirement will better align the interests of originators and securitizers with those of investors.

Moreover, a clear lesson of the Levin hearings is that Congress must ban the widespread issuance of stated income loans.

I understand Senator Levin is developing further reform proposals based on his conclusions from the hearings.

Third, we must concentrate law enforcement and regulatory resources on restoring the rule of law to Wall Street. We must treat financial crimes with the same gravity as other crimes because the price of inaction and a failure to deter future misconduct is enormous. That's why I'm pleased the SEC is turning the page on its recent history and sending a message throughout Wall Street: fraud will not pay.

Mr. President, last week's revelations about Washington Mutual and Goldman Sachs reinforce what I've been saying for some time. Deregulation was based on the view that rational actors would operate in their own self-interest within a framework of law. But even with the most rigorous regulators, it is impossible to trace the financial self-interest of convoluted financial conglomerates, much less constrict their behavior before it runs afoul of the law. WaMu made loans they knew could not be paid back. Goldman Sachs allegedly permitted clients to take secret positions against the very financial products that it had created.

The picture being revealed by the jigsaw puzzle of multiple investigations is now emerging clearly in my eyes. These financial institutions are too big and conflicted to manage, too big and conflicted to regulate, and too big to fail. Even Alan Greenspan has said about our current predicament: "If they're too big to fail, they're too big."

Our country took a giant step backwards during the last financial crisis, upending the dream of home ownership for millions of Americans, and throwing millions of people out of work as well. The credibility of our markets, one of the pillars of our economic success, was badly damaged. It must be restored. There must be structural and substantive change to Wall Street,

where bankers must resume their central role of efficiently allocating capital, not taking bets in opaque markets that no one can understand.

The solution is clear. We must split up our largest financial institutions into more manageable entities; we must separate their component parts so they are no longer inherently conflicted and so they can be properly regulated. Only then, if necessary, can they be allowed to fail without sending our entire economy to the precipice of disaster.